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EFFICIENT MARKET HYPOTHESIS

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If you follow the Efficient Market, and related Random Walk Hypotheses, you can Buy and Hold Index Funds, and/or ETFs, and probably outperform most mutual funds, and most individual investors.

In an Efficient Market stock prices reflect all available information. Prices change over time in a Random Walk manner, with no predictable pattern.

There are 3 levels of the Efficient Market Hypothesis (EMH):

1. "Weak" asserts that future price changes will occur randomly, by unknown future events, so technical analysis is of no use. Fundamental analysis can still yield useful information on future price changes.

2. "Semistrong" asserts that all publicly available information is fully reflected in stock prices, so fundamental analysis is also of no value.

3. "Strong" asserts that all information is fully reflected in stock prices, so even inside information is of no value.

Professor Eugene Fama developed the EMH in the 1960s at the University of Chicago.

EMH only works because many intelligent investors and analysts are continually analyzing financial information on stocks, and buying or selling based on their evaluation of price versus value.

Large company prices are most strongly determined by EMH because they are followed by hundreds of analysts at investment companies and mutual funds.

Markets are much more efficient now than 30 years ago because the Internet, TV, and telecommunications disseminate new information immediately.

EMH does NOT prevent "irrational exuberance" developing like the late 1990s bubble, nor major corrections like the 23% drop on 10/19/87.

EMH Believers: John Bogle, Vanguard; Burton Malkiel, Princeton; Jeremy Siegel, Wharton; Warren Buffet, Peter Lynch; Bill Sharpe, Stanford; Mert Miller, Chicago

THE INVESTING CASINO the only positive return gambling casino in the world.
You can simply Buy Index Funds and/or ETFs in the Lobby; or go upstairs and make bets on tens of thousands of stocks, mutual funds, bonds, REITs, ponzi schemes, etc. etc.
Possible bargain basement games: closed end funds & quant funds.

BENCHMARKS: SBBI annualized Total Returns over the last 80 Years 1926-2005

Large Co. Stocks:	10.4%	Inflation	3.0%
Small Co. Stocks	12.6%		
Intrmdt. Gov Bonds	5.3%		
US Tsy Bills	3.7%		

INVESTING STRATEGY Passive Investing (Buy & Hold Index funds & ETFs) has outperformed active mutual funds and individual investors over most past time periods.

John Bogle estimates in the 20 years 1985-2004, when the S&P 500 average total return was 13.2.%, the average equity fund return was only 10.4%, and the average fund investor return was only 7.1%. Factors causing the shortfalls included: fund average expense ratio of 1.5%, and 100% annual turnover costs of 1.0%. Investors were further penalized by sales load charges, tax liabilities, and a tendency to buy hot funds after they made big gains.

Dr. Terrance Odean studied stock trading in 10,00 individual accounts over 6 years, and found many costly patterns.

Other factors to consider:

ASSET ALLOCATION accounts for 90% of portfolio return variation—not stock picking, not market timing. (Brinson study) Typical AA: 60-70% equities, 40-30% fixed income. Include US & foreign equities, bonds, REITs, cash.
Conventional wisdom: reduce your equity exposure as you age.

DIVERSIFICATION is important because the Market does not pay you for taking single stock and/or single industry risk. Recommend maximum 4-10% in any one stock.

MINIMIZE EXPENSES Avoid load funds. Use low expense funds, eg Vanguard Total Stock Market ETF (VTI) has .07% expense ratio. Minimize broker costs.

<u>TAXES</u> You are NOT an Individual Investor. You run a complex partnership with 3 difficult partners: IRS, CA Franchise Tax Board, and foreign goverments. So:

Buy and Hold winners, Sell losers in taxable portfolio.
Hold index funds, muni bonds, foreign stocks/funds there.

Maximize your tax deferral opportunities: IRA, Roth, 401-K, 529 Plans, etc.
Hold REITs, taxable bonds, good high T/O funds there

References:

Bogle, John, "The Little Book of Common Sense Investing", 2007

Gibson, Roger, "Asset Allocation", 1990

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Siegel, Jeremy, "Stocks for the Long Run", 1998

Tanous, Peter, "Investment Gurus", 1997

"Stocks, Bonds, Bills and Inflation", (SBBI) 2006

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